

✓ MAY 3 1943

CHARLES ELMORE TROPLEY  
CLERK

IN THE  
**Supreme Court of the United States**  
MARCH TERM, 1943.

—  
**No. 992**  
.....

—  
N. O. NELSON COMPANY, PETITIONER,  
vs.  
GUY T. HELVERING, COMMISSIONER OF  
INTERNAL REVENUE, RESPONDENT.

—  
PETITION FOR WRIT OF CERTIORARI TO THE  
UNITED STATES CIRCUIT COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT AND BRIEF  
IN SUPPORT THEREOF.

—  
ABRAHAM LOWENHAUPT,  
STANLEY S. WAITE,  
JACOB CHASNOFF,  
H. M. STOLAR,  
NORMAN BEGEMAN,  
*Counsel for Petitioner.*



## INDEX.

### SUBJECT INDEX.

	Page
Petition for writ of certiorari:	
Statement of the case.....	2
Jurisdiction.....	5
Statute involved.....	5
Judgment and application for certiorari.....	6
Grounds on which question is substantial.....	6
Decision of lower court.....	6
Questions presented.....	7
Reasons for allowance of writ.....	8
Memorandum brief in support of petition.....	9

### TABLE OF CASES CITED.

Bank v. Hagner, 1 Pet. 455.....	12
Bass v. Sproll, 176 Wis. 371.....	12
Helvering v. Northwest Steel Rolling Mills, 311 U. S. 46.....	9, 11
Helvering v. Ohio Leather Co., 317 U. S. 102.....	6, 9, 11
Hess v. Hessel, 102 S.W. (2d) 729.....	12
Swedish American National Bank v. Merz, 179 N. Y. S. 600.....	12
White v. Meiderhoff, 281 S.W. 98.....	12

### STATUTE CITED.

Section 26 Revenue Act 1936, 49 Stat. 1648, c. 690.....	5
---	---



IN THE  
Supreme Court of the United States

---

MARCH TERM, 1943.

---

No. ....

---

N. O. NELSON COMPANY, PETITIONER,  
vs.  
GUY T. HELVERING, COMMISSIONER OF  
INTERNAL REVENUE, RESPONDENT.

---

**PETITION FOR WRIT OF CERTIORARI TO THE  
UNITED STATES CIRCUIT COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT.**

---

TO THE HONORABLE SUPREME COURT OF THE UNITED STATES:

The petitioner, N. O. Nelson Company, respectfully prays that a Writ of Certiorari issue to review the decision of the United States Circuit Court of Appeals for the Eighth Circuit in causes styled Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, vs. N. O. Nelson Com-

pany, Respondent, and N. O. Nelson Company, Petitioner, vs. Guy T. Helvering, Commissioner of Internal Revenue, Respondent, which reversed the decision of the United States Board of Tax Appeals in the first of said causes and affirmed the decision of the Board in the second of said causes.

### STATEMENT OF THE CASE.

These cases involve the liability of N. O. Nelson Company, Petitioner herein (hereinafter sometimes called "taxpayer") for surtax on undistributed profits for the years 1936 and 1937 under Section 14, Revenue Act of 1936, and involve particularly taxpayer's right to claimed credits authorized under Sections 26 (c) (1) and 26 (c) (2) of the act. c. 690, 49 Stat. 1648, which grant deductions from the tax imposed by said Section 14 upon undistributed profits.

The facts were stipulated (Tr. 15-17) and briefly were these:

The taxpayer, incorporated under the Laws of Missouri, was formed by N. O. Nelson Manufacturing Company (because of its inability to pay its debts) to continue its business pursuant to an agreement dated December 3, 1934, between taxpayer, the Manufacturing Company, and sundry creditors of the latter. Under the terms of the agreement the Manufacturing Company transferred certain of its assets with a book value of \$791,808.54 to taxpayer in consideration of its entire capital stock, \$100,000 par, the excess \$691,808.54 being paid in surplus. The transaction became effective December 31, 1934 and taxpayer commenced operations January 1, 1935.

In accordance with the terms of the agreement of December 3, 1934, cash and credit were advanced to taxpayer by Spang, Chalfant & Company and the American Radiator and Standard Sanitary Corporation (creditors of the Manufacturing Company). This indebtedness was evidenced by the notes of taxpayer, endorsed by the Manufacturing Company. Fifty per cent of the capital stock of taxpayer was deposited with each of these creditors as collateral security.

On January 21, 1936, the former agreement was amended in order to obtain for taxpayer additional time within which to pay the indebtedness then due said creditors and further extension of credit. The parties to the amending agreement are taxpayer, the two creditors above mentioned and Mercantile-Commerce Bank & Trust Company, trustee under a mortgage deed of trust given by Manufacturing Company on May 5, 1933, which though extended under the original agreement, was about to mature. Pertinent provisions of this amendment are hereinafter set forth. This agreement recites that a copy of the former agreement is attached thereto and by reference made a part thereof.

On April 1, 1936, pursuant to the amendment, taxpayer executed two promissory notes each for \$120,000.00, payable respectively to Spang, Chalfant & Co., Inc. and American Radiator & Standard Sanitary Corporation, covering the debt then due each, and also a note for \$110,000.00 to the Manufacturing Company to cover cash loaned by it to taxpayer. The last mentioned note was endorsed by the Manufacturing Company and deposited, as required by the amended agreement, with the Trustee under the mortgage of May 5, 1933.

During 1937, payments of \$30,000.00 each were made on the two \$120,000.00 notes and \$27,500.00 on the \$110,000.00 note.

The original agreement (Tr. 18-26) contains this provision with respect to dividends upon the stock of the taxpayer corporation which, as stated above was pledged thereunder as collateral with Spang, Chalfant & Co., Inc. and American Radiator & Standard Sanitary Corporation:

“ ‘ \* \* \* All dividends, if any, upon said stock \* \* \* shall be paid only out of current earnings to the respective pledgees thereof and be applied on account of any indebtedness owing to them at the time of such payment’ ” \* \* \* (Tr. 22.)

The amendment (Tr. 27-32) contains these provisions:

“ ‘ 6. (e) That all surplus funds not required for carrying on the business of the N. O. Nelson Co. will be paid ratably to the American Radiator and Standard Sanitary Corporation and Spang, Chalfant & Co., Inc., and to the Mercantile-Commerce Bank and Trust Com-

pany of St. Louis, on the notes of the N. O. Nelson Co., payable to the N. O. Nelson Manufacturing Company and pledged with the Trustee as additional security for the Mortgage Deed of Trust provided for and described in paragraph 2 hereof. (Tr. 30.)

“9. The said agreement of December 3, 1934, Exhibit A hereto, shall continue in full force and effect until April 1, 1941, and be in nowise altered, modified or impaired hereby, except to the extent that the same is hereby expressly modified.” (Tr. 32.)

For the year 1935 (its first year) taxpayer sustained a loss amounting to \$61,156.14. During the year 1936 its net income before income taxes amounted to \$21,796.48. The normal federal tax thereon (Tr. 11) amounted to \$2,473.42, and at the end of the year its earned income *deficit* amounted to \$41,833.60 (Tr. 17). In 1937 its net income before income taxes amounted to \$156,997.98. The normal federal tax thereon was \$22,389.70 (Tr. 12), and the accumulated earned surplus remaining amounted to \$92,774.69 (Tr. 17). No dividends were declared or paid in any of said years.

Taxpayer claimed a credit under Section 26 (c) (1) of the Revenue Act of 1936 of its entire adjusted net income for the years 1936 and 1937, in computing its excess profits tax, on the ground that none of such net income could have been distributed in either year “as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision deals with the payment of dividends,” and an alternative credit under Section 26 (c) (2) of the Act in computing the tax for 1937 equal to the amount actually paid on its note obligations in that year (Tr. 3-7, 50).

These credits were disallowed by the Commissioner of Internal Revenue (Tr. 7-13). On appeal the United States Board of Tax Appeals allowed the credit under Section 26 (c) (2) (Tr. 33-41). Cross appeals were taken to the United States Circuit Court of Appeals for the Eighth Circuit (Tr. 42, 48) which affirmed the Board of Tax Appeals in the denial of taxpayer's claim for credit under Section 26 (c) (1) and reversed the Board as to its allowance of the credit for 1937 under Section 26 (c) (2) (Tr. 63-70).



## JURISDICTION.

The jurisdiction of this Court is invoked under Section 240 of the Judicial Code, as amended by the Act of February 13, 1925, Chapter 229, 43 Stat. 939, 28 U. S. C. 347.

## STATUTES INVOLVED.

The federal statute involved is Section 26 (c) (1) and Section 26 (c) (2) of the Revenue Act of 1936, 49 Stat. 1648, Chapter 690 and is as follows:

### *Section 26:*

"In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax —

\* \* \* \* \*

### "(c) CONTRACTS RESTRICTING PAYMENT OF DIVIDENDS—

"(1) PROHIBITION ON PAYMENT OF DIVIDENDS—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

"(2) DISPOSITION OF PROFITS OF TAXABLE YEAR—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt, to the extent that

such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936."

\* \* \* \* \*

### **JUDGMENT AND APPLICATION FOR CERTIORARI.**

The judgment of the United States Circuit Court of Appeals was entered on February 23, 1943, and petitioner's application for rehearing was denied on March 16, 1943. This petition for certiorari was filed .....

### **WHY QUESTIONS INVOLVED ARE CRITICAL.**

(1) The Circuit Court of Appeals, in the construction of Section 26 (c) (1) of the Revenue Act of 1936 failed to apply the rule of construction, laid down by this Court in *Helvering v. Ohio Leather Co.*, 317 U. S. 102, (when construing Section 26 (c) (2) ) that the exact wording of the section controls its application, and, thereby denied to taxpayer substantial rights guaranteed by said act.

(2) The Circuit Court of Appeals by failing to apply to the construction of Section 26 (c) (1), without consideration of the result, the principal of construction developed for a correlative paragraph of the same section, has cast such uncertainty upon the meaning of Revenue Acts that administrative bodies and lower Courts must conclude that the construction depends upon the tax result, and it is, therefore, important that this Court accept jurisdiction of the question and clarify it.

### **DECISION OF THE LOWER COURT.**

The Circuit Court of Appeals disallowed the credits claimed. It construed Section 26 (c) (1) as if the requirements for the credits claimed thereunder were:

(1) That there be a written contract executed prior to May 1, 1936 by taxpayer.

(2) That payment of the credit claimed as a dividend would be in violation of a provision of such contract, and

(3) That such provision must "expressly *prohibit* the payment of dividends".

There was no question about the taxpayers' fulfillment of requirements numbered (1) and (2), but as to requirement numbered (3), the Court misstated taxpayer's contention as being that the two contracts read together "expressly prohibit the payment of any dividends". It ruled that there was no provision in the contracts which "expressly prohibit (s) the payment of dividends", that, "an implied prohibition is not available to the taxpayer", and that its requirement '(3)' had not been complied with. It accordingly held that taxpayer should be deprived of the credit claimed under Section 26 (c) (1) of the Act. (Tr. 66.)

The Court also held that taxpayer was not entitled to the credit under Section 26 (c) (2) for the reason that there was no requirement in the contract that the earnings and profits of the taxable year be paid *during the taxable year* in discharge of a debt. (Tr. 68.)

### QUESTIONS PRESENTED.

(1) Whether by virtue of a contract between a corporation and its creditors providing that "dividends shall be paid only out of current earnings" to certain creditors as pledgees of its stock, and expressly modified by subsequent contract providing that "all surplus funds not required for carrying on "the business of the corporation will be paid to certain specified creditors on account of corporation notes held by them, the corporation may, in computing its surtax on undistributed profits for 1936 and 1937 take credit under Section 26 (c) (1) of the Revenue Act of 1936 for its entire adjusted net income.

(2) Whether under Section 26 (c) (2) of the Revenue Act of 1936, the corporation under the facts above stated may take credit for \$87,500 paid to creditors in 1937, under compulsion of said contracts.

(3) Whether that portion of Section 26 (c) (1) of the Revenue Act of 1936, which reads:

“ \* \* \* which provision expressly *deals* with the payment of dividends ”

should be construed as if it read:

“ which provision expressly *prohibits* the payment of dividends ”.

### REASONS FOR ALLOWANCE OF THE WRIT.

The Circuit Court of Appeals has decided an important federal question which has not heretofore been determined by this Court, and in a manner apparently not in accord with the applicable decisions of this Court.

A memorandum brief following presents petitioner's views of the law applicable to the questions presented.

WHEREFORE, your petitioner respectfully prays that a writ of certiorari be issued under the seal of this Court, directed to the United States Circuit Court of Appeals for the Eighth Circuit, commanding said Court to certify and send to this Court for its review, a complete transcript of the records and all of its proceedings in consolidated causes No. 12,297, Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, v. N. O. Nelson Company, Respondent, and No. 12,298, N. O. Nelson Company, petitioner, v. Guy T. Helvering, Commissioner of Internal Revenue, Respondent, and that the judgment of said Circuit Court of Appeals may be reversed.

ABRAHAM LOWENHAUPT,  
STANLEY S. WAITE,  
JACOB CHASNOFF,  
H. M. STOLAR,  
NORMAN BEGEMAN,

*Counsel for Petitioner.*  
408 Pine Street,  
Saint Louis, Missouri.

STATE OF MISSOURI,  
CITY OF ST. LOUIS.—SS.:

ABRAHAM LOWENHAUPT, being duly sworn upon his oath, states that he is one of the counsellors for the petitioner

herein, and that he knows of the above proceedings, and that the facts herein sworn to are true.

ABRAHAM LOWENHAUPT.

Subscribed and sworn to before me this 28th day of April, 1943.

HELEN THOMPSON,  
*Notary Public.*

My commission expires December 27, 1945.

**MEMORANDUM BRIEF IN SUPPORT OF THE  
PETITION.**

1. The Court of Appeals determined that the taxpayer is not entitled to a credit, under Section 26 (c) (1) of the Revenue Act of 1936, against its adjusted net income because, as the Court states, the second contract relied on "does not expressly *prohibit* the payment of dividends". It bases this ruling on the decisions of this Court in *Helvering v. Northwest Steel Rolling Mills*, 311 U. S., 46, and *Helvering v. Ohio Leather Co.*, 317 U. S. 102. The Court, however, has misconstrued the opinions in those cases.

There was no written contract in question in the case of *Northwest Steel Rolling Mills*, and the question decided was whether Section 26 (c) (1) authorized a credit or deduction to corporations prohibited by state law from distributing dividends. The decision was that Section 26 (c) (1) does not authorize a credit for statutorily prohibited dividends, and that Section 26 (c) (2) allows a credit to corporations contractually obligated to set earnings aside for the payment of debts. The Ohio Leather Co. case arose under Section 26 (c) (2) and is not any authority for the Court of Appeals' ruling that Section 26 (c) (1) requires an "express prohibition of the payment of dividends". As will later appear, the Supreme Court's construction of Section 26 (c) (2) is contrary to the Court of Appeals' construction of 26 (c) (1).

Section 26 (c) (1) does not require that the contract "*expressly prohibit*" the payment of dividends, as the Court of Appeals believed. It requires only that the con-

tract expressly *deal* with the payment of dividends and that payment of dividends would be a violation of the contract.

In the case of the taxpayer, the contract of December 3, 1934, required that all dividends on its stock should be paid out of current earnings and that the payments should be to two specified pledgees of that stock. The subsequent contract of January 21, 1936 modified the earlier contract (which was attached as an exhibit to the later one, and expressly by reference made a part thereof) by providing that all surplus funds not required for carrying on the business should be paid directly to three creditors of the taxpayer, including the two pledgees of the stock. Thus, the second contract modifying the provision in the first contract, which allowed the payment of dividends and revoking that right, deals with the payment of dividends; and by requiring that *all* surplus funds, the only funds from which dividends could be paid, should be paid to the creditors of the taxpayer, makes the payment of any dividend a violation of that contract.

A distribution to the stockholders as dividends, unquestionably would have violated the provisions of the contract as amended, and this fact is conceded by the Board of Tax Appeals and tacitly recognized by the Court of Appeals. Moreover, the provisions of the contract by cancelling an expressed provision allowing the payment of dividends did *expressly* "deal with the payment of dividends" and, therefore, met that requirement of the statute. The original contract expressly dealt with dividends in the requirement that "all dividends, if any, upon stock so deposited as collateral shall be paid only out of current earnings to the respective pledgees thereof". The modifying contract dealt with this same subject when it modified the original clause which dealt with dividends, by providing that all surplus funds not required for carrying on the business of N. O. Nelson Company should thereafter be applied toward payment of specified notes. And it further expressly dealt with the subject of dividends (a) by incorporating the original contract into the second contract and expressly making it a part thereof, and (b) by expressly providing that the first contract should continue in full force and effect except as expressly modified by

the later agreement. The two contracts, therefore, expressly *deal* with the payment of dividends within the meaning of Section 26 (c) (1), and the Court of Appeals, in holding to the contrary, on the authority of *Helvering v. Northwest Steel Rolling Mills*, misconstrued and incorrectly applied this Court's decision in that case to the case before it.

This question becomes of magnified importance because of the following. In the construction of Section 26 (c) (1), Revenue Act of 1936, the Court of Appeals failed to apply the principles laid down by this Court in construing Section 26 (c) (2) of said Act.

In *Helvering v. Ohio Leather Co.*, 317 U. S. 102, this court reversed the decision of the Court of Appeals, which had construed Section 26 (c) (2) to permit the deduction because the Court of Appeals said the deduction was within the purpose of Congress. This Supreme Court ruled the deduction not allowable because the words of the section did not cover it.

In the present case, the *words of the section* cover the deduction, that is, the payment of any dividend in this case *would violate the terms of the contract*, and the contract (original with amendment) *expressly deals* with the payment of dividends. But under the Court of Appeals' construction of the statute, it is not sufficient that the contract expressly *deal* with the payment of dividends, and that the payment would violate the provisions of the contract. The Court of Appeals makes the requirement that the contract *expressly prohibit* payment of dividends, possibly because the Court believes that was the intention of Congress. There is no reason given for this construction. The question presented, of national importance, is whether this Court will insist that the lower courts apply the same technical construction of a National Revenue Act when the taxpayer is relieved thereby, as when the contrary results.

II. The Court of Appeals, in determining adversely the taxpayer's claim under Section 26 (c) (2) for credit of \$87,500 paid to creditors in the year 1936, by virtue of the provisions of the two contracts, based its decision on the stated reason that the contract relied upon contained



no express provision requiring the earnings and profits of the taxable year to be paid or set aside within the taxable year in discharge of a debt, that it does not deal expressly with the disposition of earnings and profits of the taxable year, and that "when the payments shall be made is not specified".

Since the company started the year 1937 with an earned income deficit, surplus funds in that year could mean only savings and profits of that year. Surplus funds not needed in its business as they accumulated, became immediately payable to the creditors. The rule is that if no time is specified in a contract for the payment of money, the money is payable immediately. *Hess v. Hessel* (Mo. App.), 102 S. W. (2d) 729; *White v. Meiderhoff* (Mo. App.), 281 S. W. 98; *Swedish American National Bank v. Merz*, 179 N. Y. S. 600; *Bass v. Sproll*, 176 Wis. 371; *Bank v. Hagner*, 1 Pet. 455. Therefore, the right of the creditors to the surplus funds attached as the surplus funds arose, and the company had no discretion as to the retention of such surplus funds. The question of whether the surplus funds were needed in taxpayer's business was one of fact.

The actual payment in the year 1937 of the sum of \$87,500 from the earnings and profits of the business was an admission by taxpayer that these funds were surplus funds not needed in its business. They were payable during the year because any retention of the surplus funds by the company beyond the needs of its business would have violated the contract. The provision of the contract, therefore, clearly deals with the disposition of earnings and profits of any taxable year during which they should arise, and required that those earnings and profits be paid to the creditors within the taxable year, that is, immediately as they arise if at the time they were not needed in its business.

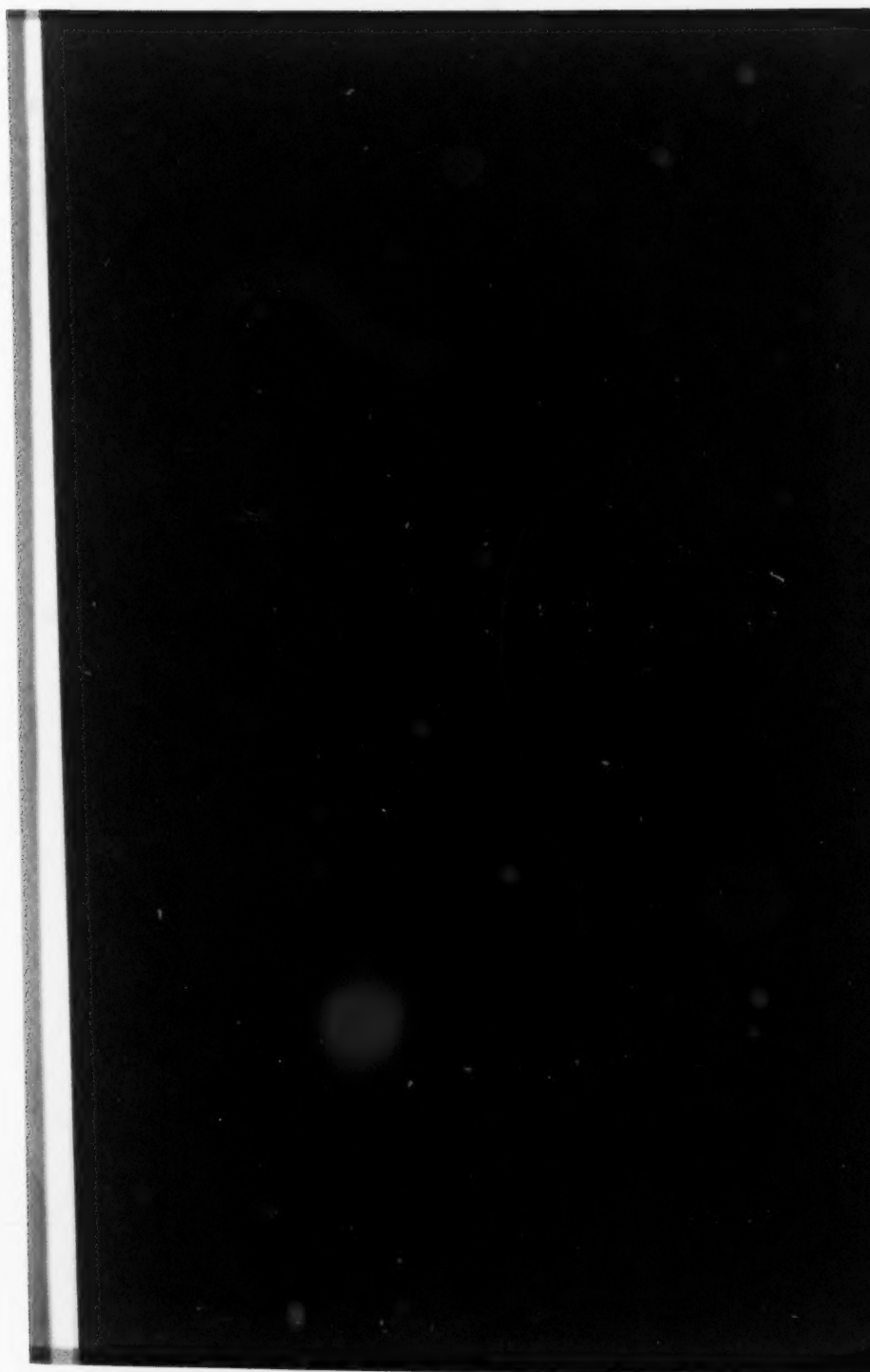
Respectfully submitted,

ABRAHAM LOWENHAUPT,  
STANLEY S. WAITE,  
JACOB CHASNOFF,  
H. M. STOLAR,  
NORMAN BEGEMAN,

*Counsel for Petitioner.*







## INDEX

	Page
Opinions below .....	1
Jurisdiction .....	1
Questions presented .....	2
Statute and regulations involved .....	2
Statement .....	2
Argument .....	6
Conclusion .....	8
Appendix .....	9

### CITATIONS

Cases:	
<i>Clark, C. C., Inc., v. United States</i> , 126 F. 2d 292 .....	8
<i>Clover Splint Coal Co. v. Commissioner</i> , 130 F. 2d 52 .....	7
<i>Helvering v. Magnus Beck Brewing Co.</i> , 132 F. 2d 379, certiorari denied, May 10, 1943 .....	7
<i>Helvering v. Moloney Electric Co.</i> , 120 F. 2d 617, certiorari denied, 314 U. S. 682 .....	8
<i>Helvering v. Ohio Leather Co.</i> , 317 U. S. 102 .....	8
<i>Nevada-Massachusetts Co. v. Commissioner</i> , 128 F. 2d 347 .....	8
Statute:	
Revenue Act of 1936, c. 690, 49 Stat. 1648, Sec. 26 .....	7, 9
Miscellaneous:	
Treasury Regulations 94, Art. 26-2 .....	10

(1)



# In the Supreme Court of the United States

OCTOBER TERM, 1942

---

No. 992

N. O. NELSON COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL  
REVENUE

---

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED  
STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH  
CIRCUIT*

---

BRIEF FOR THE RESPONDENT IN OPPOSITION

---

## OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 33-41) is reported at 45 B. T. A. 899. The opinion of the Circuit Court of Appeals (R. 62-70) is not yet reported.

## JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 23, 1943 (R. 70); rehearing was denied March 16, 1943 (R. 77). The petition for a writ of certiorari was filed May 3, 1943. The jurisdiction of this Court is invoked under Sec-

tion 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

#### QUESTIONS PRESENTED

1. Whether in computing its surtax on undistributed profits the provisions of a certain written contract, as amended, entitle petitioner to a credit of its entire adjusted net income for the years 1936 and 1937 under Section 26 (c) (1) of the Revenue Act of 1936.

2. Whether in computing its surtax on undistributed profits the provisions of the contract in question entitle petitioner to a credit under Section 26 (c) (2) of the Revenue Act of 1936 in the amount paid its creditors in 1937.

#### STATUTE AND REGULATIONS INVOLVED

The pertinent statute and regulations are set forth in the Appendix, *infra*.

#### STATEMENT

The facts, which were stipulated, may be summarized as follows:

Petitioner, a Missouri corporation, was organized by the N. O. Nelson Manufacturing Company, also a Missouri corporation, hereinafter called the Manufacturing Company, for the purpose of continuing the business of the latter company in accordance with the terms of an agreement dated December 3, 1934, between the taxpayer, the Manufacturing Company, and sundry creditors of the latter (R. 33).

Under this agreement, the Manufacturing Company, which had executed a first mortgage deed of trust for the benefit of creditors, transferred certain of its assets to the petitioner in consideration of petitioner's entire authorized capital stock and its assumption of certain liabilities. The petitioner commenced operations January 1, 1935, with a capital stock of \$100,000 and a capital surplus of \$691,808.54. (R. 33-34.)

In accordance with the agreement, Spang, Chalfant & Company and the American Radiator & Standard Sanitary Corporation advanced the petitioner cash and sold merchandise to it on credit in the aggregate amount of \$120,000 each by March 31, 1936. It was agreed that this indebtedness was to be evidenced by notes of the petitioner endorsed by the Manufacturing Company. It was further agreed that 50% of the petitioner's capital stock was to be deposited with Spang, Chalfant & Company and the other 50% with the American Radiator & Standard Sanitary Corporation as collateral to secure payment of merchandise purchased by the petitioner on credit. The agreement also contained the following statement (R. 34):

All dividends, if any, upon said stock so deposited as collateral shall be paid only out of current earnings to the respective pledgees thereof to be applied on account of any indebtedness owing to them at the time of such payment. \* \* \*

In order to secure additional time for the payment of this indebtedness, and for other purposes, an agreement dated January 21, 1936, was entered into between the petitioner, the Manufacturing Company, the American Radiator & Standard Sanitary Corporation, Spang, Chalfant & Company, and the Mercantile-Commerce Bank & Trust Company, the latter acting for the creditors for whose benefit the mortgage deed of trust was executed. In accordance with the terms of this agreement, the petitioner on April 1, 1936, executed promissory notes in the amount of \$120,000 each in favor of Spang, Chalfant & Company and the American Radiator & Standard Sanitary Corporation, to evidence the petitioner's indebtedness to those companies. Also, it provided that payments on the principal of the notes would not be enforced prior to April 1, 1941. No payments were made thereon in 1936, but in 1937 \$30,000 was paid on each note. (R. 34-35.) This agreement further provided as follows (R. 35):

6. (e) That all surplus funds not required for carrying on the business of N. O. Nelson Co. will be paid ratably to the American Radiator and Standard Sanitary Corporation and Spang, Chalfant and Co., Inc. and to the Mercantile-Commerce Bank and Trust Company, of St. Louis, on the notes of the N. O. Nelson Co., payable to the N. O. Nelson Manufacturing Company and pledged with the Trustee as addi-



tional security for the Mortgage Deed of Trust \* \* \*.

9. The said agreement of December 3, 1934, \* \* \* shall continue in full force and effect until April 1, 1941, and be in nowise altered, modified or impaired hereby, except to the extent that the same is hereby expressly modified.

The Manufacturing Company, beginning on or about January 1, 1935, made cash loans to petitioner which totaled \$110,000 by March 31, 1936. This indebtedness was evidenced by a promissory note of the petitioner dated April 1, 1936, which was made payable to the Manufacturing Company, endorsed by it, and deposited with the Mercantile-Commerce Bank & Trust Company, as additional security under the mortgage deed of trust. No payments were made on this note in 1936, but \$27,500 was paid to the Mercantile-Commerce Bank & Trust Company in 1937. (R. 35.)

For the calendar year 1935, the petitioner sustained a loss and for the calendar years 1936 and 1937 realized net income. Petitioner had an earned surplus for 1937 but none for the two years preceding; its original capital surplus remained substantially unchanged. (R. 35.)

The petitioner neither declared nor paid any dividends in 1936 and 1937 (R. 36).

The Board held that under the provisions of the contract in question, as amended, the petitioner was not entitled to a credit under Section 26 (c)

(1) of the Revenue Act of 1936, in computing its surtax on undistributed profits for 1936 or 1937 under Section 14 of that Act, but that it was entitled under Section 26 (c) (2) of the Act, in computing such tax for 1937, to a credit of the amount it paid its creditors from current earnings during that year (R. 37-38). Each party appealed from that part of the decision which was adverse to it. The court below sustained the Board with respect to the credit claimed under Section 26 (c) (1), but reversed the Board's ruling that petitioner was entitled to the credit claimed under Section 26 (c) (2).

#### ARGUMENT

The decision below is correct on both issues and presents neither a conflict nor a question of general importance.

1. Petitioner's argument under Section 26 (c) (1) is bottomed upon its theory that the dividend clause of the original agreement was incorporated into the amendment by reference. This theory, however, was correctly rejected by both the Board of Tax Appeals (R. 37) and the Circuit Court of Appeals (R. 66). Since the reference to dividends did not survive the amendment, there is no occasion to consider whether the section contemplates an express prohibition on payment of dividends, as the heading would indicate, or whether it requires only that the contract expressly deal with the payment of dividends.

2. Petitioner was not entitled to the credit claimed under Section 26 (c) (2) because the contract as amended contains no express provision requiring the earnings and profits of the taxable year to be paid within the taxable year in discharge of a debt.

The words of the provision relied on are "all surplus funds not required for carrying on the business." What amount is required "for carrying on the business" is not stated. Manifestly Congress did not intend the credit to depend upon the corporate discretion as to what amount of its earnings shall be used for the discharge of obligations. The credit is granted not where the corporation controls the situation, but where the creditors do.

Furthermore, the pertinent contract provision does not deal with the earnings and profits of the taxable year; it refers to "all surplus funds." That term is not defined in the contract, and its meaning is ambiguous. It may or may not have been intended to embrace funds other than current earnings. Section 26 (c) (2) requires that the contract deal "expressly" with the disposition of "earnings and profits of the taxable year"; the requirement is not to be satisfied by implication or inference. And the fact that payment is made from such earnings is quite immaterial. *Helvering v. Magnus Beck Brewing Co.*, 132 F. 2d 379 (C. C. A. 2d), certiorari denied May 10, 1943, No. 846, this Term; *Clover Splint Coal Co. v. Commis-*

sioner, 130 F. 2d 52 (C. C. A. 3d); *Nevada-Massachusetts Co. v. Commissioner*, 128 F. 2d 347 (C. C. A. 9th); *C. C. Clark, Inc. v. United States*, 126 F. 2d 292 (C. C. A. 5th); *Helvering v. Moloney Electric Co.*, 120 F. 2d 617 (C. C. A. 8th), certiorari denied, 314 U. S. 682.

Finally, there is nothing in the provision which requires that payment shall be made "within the taxable year." *Helvering v. Ohio Leather Co.*, 317 U. S. 102, 109. The words of the contract are "will be paid"—no time for payment is specified. It is to be noted too that the contract contemplates a determination by petitioner's officers at a time not stated, as to the amount which it shall retain "for carrying on the business" for a period not established; necessarily payment to the creditors named is to follow this computation.

#### CONCLUSION

There is no conflict and the decision below is correct. The petition for certiorari should be denied.

Respectfully submitted.

CHARLES FAHY,  
*Solicitor General.*

SAMUEL O. CLARK, Jr.,  
*Assistant Attorney General.*

SEWALL KEY,  
J. LOUIS MONARCH,  
MARYHELEN WIGLE,

*Special Assistants to the Attorney General.*

MAY 1943.





## APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

### SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

\* \* \* \* \*

(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on payment of dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of profits of taxable year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earn-

ings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

\* \* \* \* \*

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26-2. *Credit in connection with contracts restricting payment of dividends.*—(a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the pay-



ment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

If a corporation is restricted with respect to the payment of dividends by two or more contract provisions coming within section 26 (c) (1), only the largest of the credits computed with respect to each of such provisions, and not their sum, shall be allowable under section 26 (c) (1) and, for such purpose, if two or more credits are equal in amount, only one shall be taken into account. However, section 26 (c) (3) provides that if both section 26 (c) (1) and section 26 (c) (2) apply, only the one of such paragraphs which allows the greater credit shall be applied, and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

(b) *Prohibition on payment of dividends.*—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but cannot be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but cannot be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

The credit provided in section 26 (c) (1) is equal to the excess of the adjusted net income, as defined in section 14 (a), over the aggregate of the amounts which can be distributed within the taxable year without violating the provisions of such contract. The requirement that the provisions of the contract expressly deal with the payment of dividends is not met in case (1) a corporation is merely required to set aside periodically a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount.

\* \* \* \* \*

*(c) Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred

on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

The term "debt" as used in section 26 (c) (2) does not include an obligation of the corporation to a shareholder, as such, as distinguished from a creditor. Accordingly, amounts paid into, or set aside for, a sinking fund by a corporation for the retirement of preferred stock, pursuant to the

terms of an agreement underlying the preferred stock issue, shall not be considered as set aside for discharge of a debt. An indebtedness evidenced by bonds or other similar obligations issued by a corporation is incurred as of the date such obligations are issued, and the amount of such indebtedness is the amount represented by the face value of the obligations. For the purpose of this article a bond or other similar obligation is not issued until it is executed and delivered to a person who holds it as a debt of the corporation. Bonds issued after April 30, 1936, in exchange in refunding a preexisting issue represent debts incurred after April 30, 1936, within the meaning of section 26 (c) (2).

